OFFICE OF CITY CONTROLLER

CITY OF HOUSTON
INTER OFFICE CORRESPONDENCE

To	Mayor Bill White City Council Members	**From**	Annise D. Parker City Controller
		Date	August 26, 2004
		Subject	**July 2004 Financial Report**

Attached is the Monthly Financial and Operations Report for the period ending July 31, 2004.

GENERAL FUND – Fiscal Year 2004

Our early estimates are that we will end fiscal year 2004 with an undesignated Fund Balance of $96.2 million (compared to $83 million in FY03). This does not include $2.1 million in Sign Abatement Funds and $20 million designated for the Rainy Day Fund. This is only a preliminary figure, as the annual audit will not be complete for several months.

GENERAL FUND – Fiscal Year 2005

The projected net activity for fiscal year 2005, allowing for transfers from other funds (Water & Sewer) of $2 million, indicates a $31.1 million budget shortfall. In May 2004, we published the Controller's Office Trends Report projecting General Fund Revenues of $1.433 million, before the inclusion of the $2 million transfer from the Water and Sewer Fund. Based on the modified tax rate approved by City Council, we now project revenues of $1.428 million. City Council adopted the FY 2005 revenue budget of $1.451, with an additional $3.5 million of transfers from other funds. This month's Monthly Financial and Operating Report incorporates our Trends revenue projections and lowers our estimate for property tax revenues by $5.541 for the ½ cent reduction in the property tax rate. I have asked the Finance & Administration director for further clarification on three items that could bring our estimates closer together:

- Metro funding (in the intergovernmental category) – currently we are estimating that we will receive $10 million (the approximate amount received in FY04) and the administration is estimating $20 million.
- Other fines and forfeits – The administration's budget took this category from an estimated $2.1 in FY04 to $4.5 million in FY05, an increase of approximately $2.4 million.
- Transfers from other funds – I have asked for further clarification on a $1.5 million budgeted transfer.

ENTERPRISE FUNDS

We are currently projecting the enterprise funds at budget.

COMMERCIAL PAPER AND BONDS

The City's practice has been to maintain no more than 20% of the total outstanding debt for each type of debt in a variable rate structure. At month-end, the ratio for each type of outstanding debt was:

General Obligation	21.6%
Combined Utility System	19.4%
Aviation	17.1%
Convention and Entertainment	27.1%

Mayor Bill White
City Council Members
July 2004 Monthly Financial and Operations Report

SWAPS REPORT

The City's Swap Policy specifies that the City will track and report on the financial implications of its swap agreements on a quarterly basis. The report is to include a summary of key terms of the agreements, mark-to-market value, exposure to counterparties, credit ratings of counterparties or guarantors, and any collateral posted as a result of the Swap agreements. The report for June 30, 2004 is included as an attachment to this letter.

NEW MFOR FORMAT

You probably noticed that the MFOR is somewhat "lighter" this month. My office has been working with F&A to develop a more streamlined version of the MFOR. The goal is to continue to bring the most significant aspects of the report to you monthly while providing the longer version to you on a quarterly basis. This will, hopefully, provide Council Members with the information needed to make sound fiscal decisions, while freeing up staff time in both F&A and the Controller's Office so that these employees can work on other tasks. Your input on this new format is encouraged.

Respectfully submitted,

Annise D. Parker
City Controller

City of Houston, Texas
Swap Agreements Disclosure
June 30, 2004

I. General Obligation Swap

On February 20, 2004 the City entered into a synthetic reduced variance coupon swap with RFPC, LLC ("RFPC" or "the Counterparty"). This swap was a negotiated transaction.

Objective. The objective of the swap is for the City to reduce its fixed rate debt service costs through a swap structure that takes on basis risk.

Terms. The City will pay a variable rate and receive a fixed rate of return on a notional principal value of $200,000,000, with the underlying bonds being various maturities of PIBS issued between 1998 and 2002. The City pays an amount equal to 5% plus the tax-free BMA rate divided by .667 minus the taxable six-month LIBOR minus a constant of 69 basis points, up to a maximum of 10%. The City receives a fixed rate of 5% from RFPC. The variable rate is fixed for each budget period. The agreement is effective from March 1, 2004 to March 1, 2023. Starting in fiscal year 2017, the notional value of the swap declines as the principal amount of the associated debt is repaid in varying amounts until the debt is retired in 2023. Based on the initial agreement, the City will receive its first payment of $500,000 on March 1, 2005. After that date a payment will be received or made every six months based on the indexes for the prior budget period.

As of June 30, 2004 the swap created a synthetic variable-rate bond as follows:

	Terms	Rate (%)
Variable rate payment to counterparty	Fixed Rate	5.0000
	BMA/0.667	1.5590
	-LIBOR	-1.1600
	-Constant	-0.6900
	Subtotal	4.7026
Fixed rate payment from counterparty	Fixed	5.0000
Net interest rate swap receipt (payment)		0.2974

The average rate for the underlying PIBS bonds is 5.19%. This swap reduces the effective rate to 4.8926%.

Fair value. RFPC has reported the fair value of the swap to be negative $1,241,000 as of June 30, 2004. The City is independently verifying this value using the zero coupon method. This method calculates the future net settlement payments required by the swap, assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These net payments are then discounted using the spot rates implied by the current yield curve for hypothetical zero-coupon bonds due on the date of each future net settlement on the swaps.

Credit risk. As of June 30, 2004, the City was not exposed to credit risk because the swap had a negative fair value. However, if implied forward prices increase and the fair value of the swap becomes positive, the City will be exposed to credit risk on the swap in the amount of its fair value. The swap counterparty has not been rated by the rating agencies. To mitigate this potential credit risk for an unrated counterparty, the counterparty has purchased a surety bond from Ambac Assurance Corporation, a AAA rated insurance company. The City's obligation is also insured by Ambac. Should Ambac's rating decline in the future, RFPC will be required to hold collateral for the City.

Interest rate risk. The City has an exposure to interest rate risk because it is paying a variable rate on the swap. However, this risk is mitigated because the payment formula has a BMA-based variable component that is offset by subtracting a LIBOR variable component.

Basis risk. The City is relying on a relationship between the taxable LIBOR index and the tax-free BMA index to gain advantage in the swap. Should marginal tax rates decline, the BMA/LIBOR ratio will increase, and the City's savings from the swap will be reduced. Conversely, if marginal tax rates rise, the City's savings will increase.

Termination risk. The City may terminate the swap for any reason. RFPC may terminate the swap if the City or the credit provider fails to perform under the terms of the contract. If the swap has a negative fair value at the time of termination, the City will be liable to RFPC for that payment. The agreement provides that the termination payment may be made in equal installments from time of termination up to termination date of the agreement in 2025.

II. Combined Utility System Swaps

On June 10, 2004 the City entered into three pay-fixed, receive-variable rate swap agreements with identical rates. The City pre-qualified six firms to submit competitive bids on the swap. The bidding took place on June 7, 2004. The three firms selected all matched the lowest fixed rate bid of 3.7784%.

Objective. The objective of the swaps is to protect against the potential of rising interest rates in conjunction with the City's Combined Utility System 2004B auction rate variable interest bonds ("2004B Bonds") and to achieve a lower fixed rate than the market rate for traditional fixed rate debt at time of issuance of the 2004B Bonds.

Terms. The notional amount of the swap agreements totals $653,325,000, the principal amount of the associated 2004B Bonds. The City's swap agreements contain scheduled reductions to outstanding notional amounts that follow anticipated payments of principal of the 2004B Bonds in varying amounts during the years 2028 to 2034.

Under the terms of the swaps, the City will pay a fixed rate of 3.7784% (lower than the rate for fixed rate debt at time of issuance) and receive a floating rate equal to 57.6% of One-Month US Dollar LIBOR plus 37 basis points. All agreements were effective June 10, 2004, the date of issuance of the 2004B Bonds. The termination date is May 15, 2034.

At June 30, 2004, the effective rate on the bonds associated with the swap was computed as follows:

	Terms	Rate (%) Received/ (Paid)
Variable rate payment from counterparties	LIBOR x 57.6%	0.67896
	+ Constant	0.37000
		1.04896
Fixed rate paid to counterparties	Fixed	(3.77840)
Net rate (paid)/received for swap		(2.72944)
Average variable rate paid on 2004B bonds		(1.18333)
Plus dealer and auction fees on 2004B bonds		(0.2530)
Effective rate of 2004B bonds		(4.16577)

In contrast, the fixed rate the City paid on its Combined Utility System Series 2004A fixed rate bonds was 5.0795%.

Fair value. Because interest rates have declined, the swaps had a negative fair value of $14,647,808 as of June 30, 2004. This value was calculated using the zero-coupon method. This method calculates the future net settlement payments required by the swap, assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These net payments are then discounted using the spot rates implied by the current yield curve for hypothetical zero-coupon bonds due on the date of each future net settlement on the swaps. The negative value may be countered by reductions in total interest payments required under the variable rate 2004B bonds, creating lower synthetic fixed interest rates.

Credit risk. As of June 30, 2004, the City was not exposed to credit risk because the swaps had a negative fair value. However, should interest rates increase and the fair value of the swap become positive, the City would be exposed to credit risk on the swap in the amount of its fair value. The City's swap policy generally requires that swap counterparties be rated double-A or better by at least one nationally recognized rating agency. As of June 30, 2004, the ratings of the three swap counterparties all met this standard (see below). Also, under the agreements, if a counterparty's credit rating falls below double-A, collateral must be posted in varying amounts depending on the credit rating. No collateral has been required to date.

Counterparty	Notional Amount	Fair Value	Counterparty Credit Rating (Moody's /S&P /Fitch)
Goldman Sachs	$353,325,000	$ (7,890,660)	Aa3 /A+ /AA-
Bear Stearns Capital Markets	150,000,000	(3,378,574)	AAA / AAA / --
UBS AG	150,000,000	(3,378,574)	Aa2 /AA+ /AA+
TOTAL	$653,325,000	$ (14,647,808)	

Basis risk. The City is exposed to basis risk on the swaps because the variable payment received is based on an index other than BMA. Should the relationship between LIBOR and BMA move to convergence (because of reductions in tax rates, for example), the expected cost savings may not be realized. The City has issued tax-exempt auction rate bonds with an average rate of 1.18333% (not including dealer and auction agent fees) as of June 30, 2004, whereas the associated LIBOR-based rate of the swap was 1.04896%.

Termination risk. The City may terminate for any reason. A counterparty may terminate a swap if the City fails to perform under the terms of the contract. If a swap should be terminated, the associated variable-rate bonds would no longer carry synthetic fixed interest rates. Also, if at the time of the termination the swap has a negative fair value, the City would be liable to the counterparty for a payment equal to the swap's fair value.